Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1992

FIRST FIDELITY BANK, N.A. NEW JERSEY,

Petitioner,

v.

THEODORE RUDBART, NATALIE RUDBART, BEVERLY LITOFF, BENJAMIN WELTMAN, MADELINE OKIN FOR HERSELF AND ON BEHALF OF ALL OTHER PERSONS SIMILARLY SITUATED, AND NORTH JERSEY DISTRICT WATER SUPPLY COMMISSION,

Respondents.

Petition For Writ Of Certiorari To The Supreme Court Of New Jersey

BRIEF IN OPPOSITION ON BEHALF OF NORTH JERSEY DISTRICT WATER SUPPLY COMMISSION

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STATEMENT OF THE CASE

The North Jersey District Water Supply Commission ("NJDWSC") is a public entity of the State of New Jersey that operates a public water supply system serving northern New Jersey.

On June 15, 1984, it issued $75,000,000 in project notes in registered form. First Fidelity Bank, N.A. was one of the three underwriters of this issue and it also became registrar and paying agent for interest payments on these 7 and 7/8% notes, paying interest by mail each June 15 and December 15 after issuance. The underwriters paid $73,800,000 for the notes and made a gross profit of $1,200,000 on their resale in the secondary market.

NJDWSC determined to redeem the notes on June 23, 1986. In September 1985, NJDWSC funded First Fidelity, as redemption Trustee, with Treasury bills and notes which, with interest earnings, was sufficient to pay the December 15, 1985 and June 15, 1986 interest payments and to effect redemption on June 23, 1986 at a 1% premium, or a total redemption price of $75,750,000.

The offering statement and the notes themselves provided for early redemption at the option of NJDWSC. Notice of redemption was to be by publication. It is undisputed that published notice was given in conformity with the notice provisions as set forth in the offering statement and on the notes themselves.

On the redemption date, First Fidelity converted the Treasuries it was holding into cash and placed that cash in a demand account. It then paid the redemption price

on the notes surrendered for redemption. Full redemption did not take place on the designated redemption date.

When some of those who had not obtained redemption did not receive the December 15, 1986 interest payment expected, complaints were made to NJDWSC which then learned for the first time that full redemption had not taken place. At this time, First Fidelity was in possession of approximately $10 million in unredeemed funds. It refused the request of NJDWSC to place that fund in an interest bearing account. At the urging of NJDWSC, however, First Fidelity did notify those who had not redeemed by mail and redemption was completed in January 1987.

The plaintiff class consists of those who had not redeemed by December 15, 1986. When redemption finally took place, interest was paid only to the redemption date of June 23, 1986. Members of the plaintiff class seek damages for the hiatus in interest between June 23, 1986 and their redemption date in January 1987.

The trial court held plaintiffs to the literal terms of their contract and dismissed the complaints. (A-75). The Superior Court, Appellate Division, reversed, holding that the notes were contracts of adhesion subject to judicial reformation on fairness grounds. Holding that notice by publication was unfair when the name and address of each noteholder was available for notice by mail, the court reversed and directed a judgment of liability against First Fidelity and NJDWSC. *Rudbart v. Dist. Water Supply Com'n*, 238 N.J. Super. 41, 568 A.2d 1213 (App. Div. 1990) (A-53).

The New Jersey Supreme Court accepted the case for review primarily to consider the application of the contract of adhesion analysis to the notes. *Rudbart v. Water Supply Com'n.*, 127 N.J. 344, 347, 605 A.2d 681, 682 (1992) (A-5).

While the case was awaiting decision, the New Jersey Supreme Court called for supplemental briefing on theories of recovery which had been advanced by the plaintiff class, other than the contract of adhesion claim. One of these theories, not reached at either the trial or intermediate appellate level, was constructive trust. The class plaintiffs claimed that First Fidelity was a constructive trustee for their benefit of the unredeemed funds and that it should be made to disgorge to them its earnings on the fund. The same theory was advanced against NJDWSC and plaintiffs sought recovery from it to the extent, if any, that NJDWSC benefitted from such earnings.

The New Jersey Supreme Court accepted the constructive trust analysis. It held that First Fidelity or NJDWSC or both were subject to liability to the extent of any financial benefit from profit on the unredeemed fund.

The New Jersey Supreme Court upheld the validity of the publication notice. Its analysis leading to the imposition of liability upon First Fidelity was very narrow. As the dissenting opinions point out, there is a seeming inconsistency between upholding notice by publication and imposing liability on First Fidelity for failure to give a more efficient notice to the noteholders.

It is undisputed that as underwriter, First Fidelity sold notes of the issue to its investment customers. Those who purchased the notes from First Fidelity were given

direct notice of the redemption either by telephone or mail or both. This is a usual brokerage service and is designed to interest the customers in purchasing a replacement issue.

The New Jersey Supreme Court held that First Fidelity could not, in fairness, pick and choose those among its customers who were to receive direct notice. It held that having chosen to notify directly those customers who had purchased from it, First Fidelity had a duty also to notify those for whom it was acting as registrar and paying agent. On this narrow and limited analysis, First Fidelity was subjected to liability to the plaintiff class by way of disgorgement of its earnings on the unredeemed fund, with credit for costs of management.

The New Jersey Supreme Court specifically disclaimed any reliance on federal law or state statutes in reaching its decision. 127 N.J. at 367, 605 A.2d at 693 (A-31) and disclaimed any intent to imply or create a private right of action arising from federal or state regulatory requirements. This was purely a common law decision.

ARGUMENT

POINT I

The Decision of the New Jersey Supreme Court in No Way Conflicts With First Fidelity's Obligation Under Federal Statutes and Regulations. In fact, it is Consistent with Federal Law. First Fidelity is Asking This Court to Decide an Hypothetical Question.

First Fidelity claims that the decision of the New Jersey Supreme Court requires it to breach the "Chinese

Wall" federal statutes and regulations require it to build around its trust department.

The class certified in the cases now before this court consists of those bondholders who had not redeemed by December 15, 1986, which would have been an interest payment date but for the redemption. At that time, there was in the possession of First Fidelity approximately $10 million in unredeemed funds. The debentures and the offering statement explicitly stated that no interest would be paid after a redemption date. This was not in furtherance of some nefarious scheme to frustrate redemption and to earn on the unredeemed portion of the fund. It was designed to encourage timely redemption. If the noteholders could have delayed redemption while continuing to collect interest, the redemption, and the economic benefit it brought to the issuer because of a falling interest rate, would have been frustrated.

The decision below does not impair this purpose of no interest payment after redemption. While the rate of earnings by First Fidelity during the hiatus between redemption date and actual redemption has not yet been determined, it should need no proof to recognize that it will not come anywhere near the rate that could have been earned upon replacement investments purchased on or close to the redemption date.

On the redemption date, First Fidelity placed the redemption fund in a demand account and issued checks to pay the redemption price of bonds already presented for redemption.

Those bondholders who did not know of the redemption and expected an interest payment on December 15,

1986 are the members of the present plaintiff class. Full redemption took place in January 1987 after the bank, at the urging of the Commission, gave mail notice of the redemption to those who had not redeemed.

The bank, however, paid interest only to the June 23, 1986 redemption date. Obviously, the bank earned on the unredeemed portion of the fund until full redemption took place. The class plaintiffs seek interest for the approximate seven month period during which their bonds were unredeemed and paid no interest. The holding of the New Jersey Supreme Court is, in short, that the bank must disgorge to the late redeemers its earnings on this portion of the fund, with credit for any costs of management.

It is unquestioned that the bank, which acted as underwriter, (along with two other entities), registrar and paying agent and redemption trustee, sold some of the issue to its customers. It also is unquestioned that the bank's investment department gave telephone or mail notice of the redemption to those who had purchased this issue from it. This was in accord with usual brokerage business practice and in an effort to sell replacement securities.

The New Jersey Supreme Court reasoned that the bank could not pick and choose among its customers to whom this direct notice would be given. It held that the bank, having given such notice to some of its customers was, in fairness, obliged to give such notice to all – including those for whom it was acting as registrar and paying agent. Upon this analysis, the Court imposed a

duty on the bank to disgorge its earnings on the unredeemed fund to the late redeemers.

The position of First Fidelity is that it has a viable federal defense to this state law unjust enrichment claim which the New Jersey courts dishonored.

The bank argues that its duties with respect to investment of the unredeemed portion of the fund are governed by 12 C.F.R. 9.10(a). However, there is nothing inconsistent between this regulation and the decision below. The regulation states that funds awaiting distribution shall not be held uninvested any longer than is reasonable for management of the account. This provision requires First Fidelity to have invested the unredeemed fund. What the Supreme Court of New Jersey has done is to require First Fidelity to act consistently with this regulation, for requiring funds awaiting distribution to be invested can exist only for the benefit of the distributees.

First Fidelity also relies on 12 C.F.R. 9.7(d) which requires National Banks exercising fiduciary powers to take steps to avoid violations of securities laws, especially those prohibiting insider trading.

First Fidelity does not state, nor could it state, what securities law or regulation the decision below requires it to violate. First Fidelity does not state that the ruling of a common law court that, if it notifies some customers of information pertinent to their investment, it must notify all, counters some federal inhibition curtailing it from so acting.

First Fidelity (A-12) poses the hypothetical that if its investment department recommends that certain securities should be sold as no longer viable investments, does the trust department have a duty to communicate this information to its customers who might be holding the same security? If the investment department, after study, determines that a security is no longer a good investment, what securities law violation would there be in divulging that information to the trust department for its consideration in advising its customers who are holding the same security? We suggest that there is none.

There is no suggestion in this case that insider trading was involved. The record does not contain the dates during which the investment department notified its customers of the redemption and offered to sell replacement securities. There is no evidence that this took place before the published notice of redemption. It if did, then insider trading might be involved. One with non-public information that there was to be a redemption at a 1% premium, might have been able to make a small but certain undeserved profit by buying from those that did not know of the redemption and the premium.

If a department of a bank is asked to finance and supervise a tender offer, obviously other departments cannot be privy to such information until it becomes public. If other departments began trading in the target's stock before the offer was made public, that clearly would be illegal insider trading.

If the loan department of a bank turns down a loan on the ground that the corporate borrower is about to go under, obviously it cannot inform other departments of

that fact in order that any bank customers or the bank itself quickly unload any securities held in the rejected borrower. That, again, would be insider trading.

There is nothing in the present case which in any way implicates a violation of securities laws or regulations.

The prospect of a common law court imposing liability upon a bank because it did not take action which would have violated securities laws does not present a real world scenario. Should that unlikely event occur, then and only then will a ripe controversy be presented. The speculations of First Fidelity about the possible downstream ramifications of the decision below do not present an appropriate vehicle for review by this Court.

POINT II

The Argument That the Res Judicata Effect of The Federal Judgment in The Related *Ellovich* Litigation Bars The Present Action is Specious Because No Valid Federal Claim For Interest on The Unredeemed Fund Could Have Been Made.

As is noted by petitioner, a federal action was brought by a Joseph Ellovich seeking the same relief as the plaintiffs in the present state court action. *Ellovich* did not succeed in surviving summary judgment on his 10b-5 claim. It is conceded that the class certified in the *Ellovich* case included the class plaintiffs in the present action.

Petitioners point out that 12 C.F.R. 9.10(a) is a regulation promulgated by the Comptroller of the Currency regulating National Banks in the matter of investing funds held in a fiduciary capacity which are awaiting

investment or distribution. From this regulation, petitioners postulate an argument that a federal claim for interest on the unredeemed fund could have been made and since it was not made in the *Ellovich* case, res judicata bars making it in a later state court action.

We have no quarrel with the argument that res judicata principles apply to class actions and we also have no quarrel with the proposition that if a viable federal claim could have been made for interest on the unredeemed fund, its absence in the federal case might well preclude a later common law claim in a state court action seeking the same relief.

The trouble is that the predicate for the argument is wrong. The regulation cited does not give rise to a federal claim. Federal courts simply would not imply a private right of action for damages arising from a National Bank's violation of 12 C.F.R. 9.10(a). *Cort v. Ash*, 422 U.S. 66 (1975); *Middlesex Cty. Sewerage Auth. v. Nat. Sea Clammers*, 453 U.S. 1 (1981). The short of it is that the regulation evidences no intent to create such a right of action, assuming, as it is difficult to do, that the Comptroller of the Currency has the power to create one.

The cases cited by petitioner (A-17) have nothing to do with private rights of action arising out of the Comptroller's regulations. They deal with branch banking and banking services in implementation of the Congressional policy to keep state and National Banks on a plane of competitive equality.

Since there could have been no federal claim, but only a state common law claim for interest on the unredeemed fund, and since the federal 10b-5 issues were

eliminated prior to trial, the pendent state law claims were properly left for state court resolution. *United Mine Workers v. Gibbs*, 383 U.S. 715 (1966).

POINT III

There Was No Due Process Violation By The New Jersey Supreme Court in Not Affording The Parties an Opportunity to be Heard and, Hence, There is No Federal Question For This Court to Review.

What took this case to the New Jersey Court was the rather startling holding of the Superior Court, Appellate Division, that every debt or equity security issued in New Jersey was subject to contract of adhesion reformation by the New Jersey Courts. *Rudbart v. Water Supply Comm'n*, 127 N.J. 344, 347, 605 A.2d 681, 682 (1992) (A-5).

There can be no question, however, that the plaintiffs, among their theories of recovery, sought restitution on the ground that the parties defendant had been unjustly enriched by earnings on the unredeemed portion of the redemption fund for a period of approximately seven months.

The New Jersey Supreme Court, apparently discerning no fact controversy surrounding the events that gave rise to this case, decided to call for supplemental briefing and decide the available legal issues. *See* 127 N.J. at 361, 605 A.2d at 689 (A-23).

The issue of unjust enrichment was briefed by the parties. Plaintiffs took the position that as a fiduciary, First Fidelity had a duty to invest the unredeemed portion of the funds, and, as the opinion notes, 127 N.J. at

367, 605 A.2d at 692 (A-31), were willing to concede that the fund could remain uninvested for a short period.

First Fidelity was an underwriter for the $75 million issue, as well as registrar and paying agent for the semi-annual interest and also redemption trustee. The record does not reveal what portion of the $75 million was underwritten by First Fidelity. Two other underwriters participated. First Fidelity did sell the issue in question to its investment customers. Its employees did by phone or mail notify the customers who had purchased the issue from it of the redemption. This was part of the usual brokerage service provided and also was in an effort to sell those customers replacement issues.

The New Jersey Supreme Court posited its imposition of liability on First Fidelity on the proposition that it could not notify only some of its customers directly of the redemption. It could not pick and choose those whom it would notify. Once it determined to notify, it had a duty to notify all – those who bought from it and those for whom it was acting as registrar and paying agent and redemption trustee.

It is clear that no party ever argued to the New Jersey Supreme Court this precise avenue of analysis. However, the subjection of First Fidelity to disgorge an unjust enrichment was presented.

The parties were heard on the unjust enrichment theory. Just because the Court chose to posit liability under that theory pursuant to an analytical path not precisely argued does not violate due process. It is akin to this Court's action in *Middlesex Cty. Sewerage Auth. v. Nat. Sea Clammers*, 453 U.S. 15, 19 (1981) in which this Court

addressed an issue not advanced by any party in order to put an end to the litigation. That action, clearly not a violation of due process, is more arguably subject to criticism than the New Jersey Supreme Court's action in imposing liability upon a theory clearly pleaded and argued, but by an analysis somewhat divergent from that presented to it.

There simply was no due process violation and, hence, no federal question to review.

CONCLUSION

It is respectfully submitted that the petition of First Fidelity Bank, N.A., for a writ of certiorari to the Supreme Court of New Jersey should be denied.

Respectfully submitted,

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